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THE REVOLT AGAINST THE DOLLAR AND TOWARD A NEW INTERNATIONAL MONETARY SYSTEM — By Dr. Gabriel P. Racz

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"Since in the Bretton Woods system, the dollar became the key or anchor currency of international trade and finance, a highly sensitive role was assigned to the United States economy and its currency."

EDITOR'S NOTES

The presidents of the two organizations that publish this magazine are presented on this page. The leaders will be assisted by a fine group of women accountants who somehow find time in their busy professional and personal lives to devote many hours to the purposes of ASWA and AWSCPA. (Their names, addresses, and assignments are shown on the inside front cover of this issue.)

OUR PRESIDENTS
1972 - 1973

Miss Guimond, ASWA

Miss Welch, AWSCPA

Madeline Guimond, the President of the American Society of Women Accountants, is office manager and accountant for University Gardens, Inc., a real estate and land development firm in Riverside, California. As such, she is responsible for the accounting and internal operations of that company and its many affiliates.

It is Miss Guimond's hope that ASWA will continue the growth and professional development of its members which have been characteristic of its past. She is sure that "with the help and enthusiasm of our chapters, we will prove our ASWA members are professional women and have the ability to become leaders in our field."

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Doris A. Welch, CPA, the President of the American Woman's Society of Certified Public Accountants, is staff accountant with the Office of the Chancellor of California Community Colleges in Sacramento, California. In that position, she handles the state's capital outlay appropriation to the college districts, advises the districts on accounting matters, and has just assisted in the implementation of a new accounting system for California's 95 community colleges.

Commenting on recent legislation which has given impetus to the goals of many women's organizations, Miss Welch stated that "recent events . . . are going to improve women's ego, strength, and add momentum to the

(Continued on page 12)

We note with great pride that Marjorie June, CPA, a former president of AWSCPA, has been nominated as a member-at-large for a three-year term on the Council of the American Institute of Certified Public Accountants. While a few women have served on Council as a result of their positions as presidents of state societies, Miss June will be the first woman elected to Council by the Institute membership.

THE REVOLT AGAINST THE DOLLAR AND TOWARD A NEW INTERNATIONAL MONETARY SYSTEM

An economist who has lived and worked both in Europe and the United States unveils some of the mystiques surrounding international monetary issues.

Dr. Gabriel P. Racz
Memphis, Tennessee

The action taken by five West European countries (West Germany, Switzerland, Belgium, Holland, and Austria) in May 1971 to "appreciate" the value of their national currencies relative to the U.S. dollar, and thereby in fact "depreciate" the value of the dollar, signaled the beginning of the end of the international monetary system set up in the closing days of World War II (1944 Bretton Woods Conference). From 1944 until 1971 the dollar had the role of anchor currency of world trade and finance. The announcement by the President of the United States on August 15, 1971 that the United States would no longer convert foreign-held dollars into gold gave official recognition to the demise of the old system.

The Development of the Bretton Woods System

Preceding the present system, the so-called "gold standard" had reigned since before World War I; it collapsed under the impact of the world-wide Great Depression in the early 1930's. Under the gold standard, the relationships of national currencies to each other (the rates of exchange) remained fixed, since the common denominator for all currencies was gold. For example, if one ounce of fine gold was worth 14.6 English pounds (£), $35, 140 German marks, or 175 French francs, the exchange rates for the currencies would be fixed at £1 = $2.40 = 9.6 marks = 12 francs. Gold was freely traded. At times, demand for gold exceeded its supply; at other times, supply exceeded demand. The fixed value of currencies was maintained by the generally accepted obligation of the Central Banks (the Federal Reserve in the U.S.) to buy gold if an excess supply developed (i.e., create gold reserves) and to sell from these accumulated gold reserves whenever the demand for gold exceeded its supply on the market. As the result of these Central Bank operations, only small fluctuations occurred around the exchange rates. The price spread or fluctuation was determined by the cost of shipping gold between the various financial centers (London, New York, Zurich, Paris, etc.). Gold reigned supreme!

During the Great Depression, nation after nation was forced to abandon the gold standard. Evaluating the gold standard system, one must note its great advantage—the fixity of exchange rates and the associated ease and certainty of international payments. On the negative side, one must recognize the fact that a nation's domestic money supply (increase or decrease) was determined by (1) the Central Banks' compensatory actions on the gold market and (2) the uncertain levels of yearly gold production. Domestic stabilization policies (i.e., monetary supply expansion in times of recession and monetary supply contraction in times of inflation) increasingly became primary national economic objectives. The stabilization

Dr. Gabriel P. Racz is Professor of Economics at Memphis State University. A native of Hungary, he studied at the University of Geneva (Switzerland), received his Ph.D. from the University of Budapest (Hungary), and has done postgraduate work at New York University. Dr. Racz was associated with the Hungarian Treasury and the Hungarian State Department prior to 1948. Since emigrating to the United States, he has taught in universities in Texas and Michigan.

He is married to Dr. Marie E. Dubke, CPA, a former president of AWSCPA and the Reviews Editor of this magazine.

goals of the nations conflicted with the Central Banks' gold market operations, which were aimed primarily at maintaining fixed exchange rates.

The demise of the gold standard left a vacuum which was filled with some experimentation with freely fluctuating rates, flexible rates, and finally with exchange controls, which became dominant from the mid-1930's until Bretton Woods. Under the controls, individuals and firms acquiring foreign claims were required to report them to the Central Bank. The Central Bank retained the foreign currencies and paid the countervalue in the national currency. The Central Bank then rationed foreign currencies to importers and individuals in a very strict administrative and restrictive manner. This practice led to a world-wide decrease in international trade and financial transactions, to economic isolation, and often to open economic warfare among nations.

The hope and objective at Bretton Woods was to create a system which would avoid the undesirable aspects of previous approaches while capturing their best features. The main effects to be avoided were: (1) the rigid exchange rates and the associated deflationary side effect of the gold standard, (2) the instability of freely fluctuating rates, and (3) the repressive and distorting techniques of exchange controls.

The system which finally emerged from all these considerations at Bretton Woods became known as the "gold exchange standard". True, gold still played a limited role in the new system as reserves and as a computational point of reference. However, the stabilization operations of Central Banks were no longer conducted by buying and selling gold. Rather, *currencies were stabilized in terms of their dollar values* and Central Banks were no longer committed to redeem their currencies in gold. *Only the United States maintained a commitment to exchange dollars held by foreign Central Banks for gold (at $35 an ounce).* In reality, therefore, the U.S. dollar became the true standard against which the value of all other currencies was fixed. Herein lies the meaning of the often heard statement that "the dollar is as good as gold". The dollar not only shared the spotlight with gold but, in fact, the U.S. dollar became supreme while gold was assigned only a supporting role.

Sources and Uses of Foreign Exchange and the Balance of Payments

The United States acquires foreign exchanges
(1) by exporting commodities,
(2) by exporting services (selling U.S. transportation, services, receiving tourists, selling insurance policies to foreigners, etc.),
(3) through inflow of foreign capital to the United States,
(4) by receiving unilateral transfers (gifts and grants to U.S. citizens from foreigners),
(5) by selling gold for foreign currencies on the world's money markets.

Export of domestically produced goods is the most important source of foreign exchange for all countries. Foreign exchanges so acquired are used by all countries
(1) to pay for import of goods,
(2) to pay for import of services,
(3) to finance loans and investments in other lands,
(4) to make unilateral transfers to other countries,
(5) to pay for monetary gold acquired abroad.

The yearly systematic tabulation of a country's international trade and financial transactions is called the balance of payments statement. The above listed ten main types of transactions are classified into four categories:

Current Trade Accounts—which are further divided into merchandise trade (exports and imports) and service transactions,

The Capital Accounts—which include both long term and short term capital movements (inflows and outflows of capital),

Unilateral Transfers—which are subdivided into private and governmental transfers.

The Gold Account—which records the im-

"The accounting profession is currently considering whether leases should be capitalized and recorded on balance sheets as liabilities—a matter which touches on many fundamental objectives and complex principles of accounting. However, our experience suggests that the first step must be the establishment of acceptable measurement techniques and disclosure of the resulting lease obligations. When these have been adequately tested in practice and understood by the financial community, the best method of presentation will probably resolve itself."

Kenneth S. Axelson, CPA
J. C. Penney and Company, Inc.
Financial Executive, July 1971

port and export of gold.

Characteristics of the balance of payments statement are: (1) both trade and financial transactions are in terms of flows (in- and out-payments from a country to the rest of the world and vice versa), (2) it is based on a double entry accounting system, and (3) the groups of items on the statement agree numerically; that is, the statement is self-balancing.

The information contained in the balance of payments is extremely useful if it is subjected to analysis to draw out its significant implications. The reader should ask: In what manner and through what processes (trade, capital, transfer, or gold transactions) is the overall balance being achieved?

It is also necessary to recognize that in the free market economies of the Western World, foreign trade and financial transactions are freely carried out by individuals and business firms without government interference. These transactions are determined by such varied economic factors as consumer preferences, the level and distribution of incomes, the prices of goods and services at home and abroad, the interest rates at home and abroad, and the foreign exchange rates relative to each other. The same economic factors operate in the other countries as well. The legitimate question can be asked then: How can one expect that the in- and out-payments will be equal? The answer is that they will not be equal except by chance. Planned autonomous (ex ante) in-payments and out-payments do not equal, but actually realized (ex post) in-payments and out-payments do.

In the likely event that the planned inflow transactions of a country are not matched by its planned outflow transactions, there are two avenues available to bring the two into equality:

using gold reserves or accommodating transactions

depreciating its currency.

In the first case, if a country has an inconsistent plan (for example: if it imports much more than it can pay for by exports), it may use its accumulated gold and other reserves and/or obtain foreign loans (accommodating transactions). In the second case, if a country lives beyond its means, the exchange rate on foreign currencies may rise (decreasing the value of the domestic currency relative to foreign currencies). The change in rates will make the cost of all imports higher, forcing a downward revision in the country's exaggerated import plans. At the same time, the selling price of the country's export goods abroad will become cheaper for the foreigners purchasing them, thereby revising (upward) the originally laggard export plans. The exchange rate of the country may continue to rise until the actually realized flows are in balance. (This is called adjustment through exchange rates). When planned autonomous in- and out-payments are not equal, a *disequilibrium* situation exists which may be a deficit disequilibrium (outflows exceed inflows) or a surplus disequilibrium (the opposite).

A country experiencing an occasional deficit in the balance of payments need not be unduly alarmed since the cause may be extraordinary and non-recurring forces. However, continuous and growing balance of payments deficits are a serious problem, an indication of the country's persistent disequilibrium situation. The three signs of a balance of payments disequilibrium are the growing presence of accommodating transactions, the market-induced rise in exchange rates, and the imposition of controls over international transactions.

Since in the Bretton Woods system the dollar became the key or anchor currency of international trade and finance, a highly sensitive role was assigned to the United States economy and its currency. Therefore, the U.S. balance of payments statement must be carefully analyzed to understand the nature of changes which led to the present-day international monetary instability.

The Changing Character of the U.S. Balance of Payments

The U.S. balance of payments displays three distinct stages of development from 1945 to date. The first stage, embracing the years 1946-1949, was characterized by huge balance of payments surpluses, the period of dollar shortage. The second (1950-1957) was a transition period, characterized by small planned deficits. The third stage (1958 until today) shows persistent, unplanned, and rapidly growing deficits and is sometimes called the period of dollar glut.

Table I summarizes the trade and accommodating transactions in the first period. In the immediate postwar years, the war-devastated economies of Western Europe were reconstructed and rehabilitated. All the needed machinery, equipment, and even raw materials and food supplies could come only from the United States. To reduce substantially the required time for reconstruction of foreign economies, the United States adopted a variety of financial aid programs in the form of grants and loans. (The so-called Marshall Plan provided about $25 billion.)

Analyzing Table I, it is evident that the United States export (trade account) surplus could not have been nearly so large without the grants and loans which the U.S. Government extended to European countries which had no dollars to pay for their large import needs. It is correct, therefore, to say that the grants and loans were made as a result of the acute dollar shortage.

Table II summarizes the relevant data for the transition period of 1950-1957. The improved dollar payments position of the world shows up clearly in the increase in dollar balances held abroad ($8.6 billion) and gold

TABLE I
U.S. Balance of Payments
1946-1949
(in billions of dollars)

Exports of goods and services (excluding military transfers)			$67.0
Imports of goods and services			35.1
Excess of exports			$31.9
Means of financing excess exports:			
Private capital (long and short term)		$2.9	
Private remittances		2.5	
U.S. government financing:			
Loans	$11.7		
Grants (excluding military transfers)	13.1	24.8	
Errors and omissions		(3.1)	
Total net financing			27.1
Excess of export balance over financing			$ 4.8
Means of financing surplus:			
Liquidation of gold and other assets			$ 4.8

Source: U.S. Department of Commerce, *Survey of Current Business*, various issues.

acquired by foreign countries ($1.7 billion). One could argue that not only had the dollar shortage ended, but its opposite, a dollar glut, was already starting to develop. Dollar glut refers to the presence of a balance of payments surplus for other countries vis-a-vis the United States, i.e. a U.S. balance of payments deficit.

The third period data are summarized in Table III. Since the current account displays a large surplus, it is clear that the $32 billion deficit was caused by the disproportionally huge size of the capital and unilateral transfer accounts. To put it another way, the deficit reflects the failure of the current account to

TABLE II
U.S. Balance of Payments
1950-1957
(in billions of dollars)

Exports of goods and services (excluding military transfers)		$156.3
Imports of goods and services		134.4
Excess of exports		$ 21.9
Means of financing excess exports:		
Private capital (net)*	$10.8	
Private remittances	4.7	
U.S. Government grants and loans (net)	20.0	
Errors and omissions	(3.3)	
Total financing		32.2
Excess of financing over export balance		$ 10.3
Means of financing deficit:		
Increase in foreign U.S. balances and short term claims (net)		$ 8.6
Purchases of gold from U.S. (net)		1.7
Total		$ 10.3

*U.S. capital outflow, less long term foreign investments in the United States

Source: U.S. Department of Commerce, *Survey of Current Business*, various issues.

TABLE III
U.S. Balance of Payments
1958-1969
(in billions of dollars)

Exports of goods and services (excluding military transfers)		$392
Imports of goods and services		340
Excess of exports		$ 52
Means of financing excess exports:		
Private capital (net)	$26	
Remittances and pensions	9	
U.S. Government grants and loans	38	
Errors and omissions	11	
Total financing		84
Excess of financing over export balance		$ 32
Means of financing deficit:		
Increase in liabilities to foreigners, plus decrease in gold and foreign exchange reserves		$ 32

Source: U.S. Department of Commerce, *Survey of Current Business* and *Federal Reserve Bulletin* (April, 1970), Table I, p. 316.

adjust fully to changes in the capital and unilateral transfer accounts.

In analyzing the reasons for the failure of the U.S. balance of payments to maintain an equilibrium, one must note that:

1) The sheer magnitude of capital outflows was caused by the heavy investments of American business firms which set up operations abroad (primarily in the Common Market, England, and Japan).

2) The non-economic (political and military) considerations, such as military aid, NATO defense, etc., average $3 billion in the first five years and moved to nearly $5 billion in the latter years of the period.

3) The competitive price conditions turned against the United States, particularly after 1965, when inflationary forces gathered momentum and kept on growing. Many American products were overpriced on the world market.

Not surprisingly, the export surplus (relative to total exports) began to decrease as noted above.

During the entire postwar period the balance of payments position of the United States seriously deteriorated. The long run trend shows that volume of world trade has expanded faster than world production. While United States imports have followed this pattern, its exports have not!

The Immediate Problem: Restoring U.S. Balance of Payments

In the years 1970 and 1971 the U.S. balance of payments deteriorated even more seriously. As the export surplus decreased rapidly (in 1970 the trade account surplus became a mere $0.4 billion), the size of the payments deficits became larger and larger. By the summer of 1971, a deficit in the United States trade account (trade deficit) developed for the first time in this century. The 1971 deficit is likely to be around $300 billion, and U.S. gold reserves have already dwindled to little more than $10 billion. The accumulated United States deficits in recent years, appearing as dollar surpluses on the balance of payments of U.S. trading partners, created a new problem. By mid-1971 some $50 billion of so-called "Eurodollars" were sloshing around in foreign money markets undermining the confidence in the U.S. dollar, the very foundation of the international monetary system.

In the most recent years, the values of currencies to each other became more and more misaligned. Under the Bretton Woods system, the rates of exchange were fixed (pegged) with only rare and infrequent changes permitted. The changing economic conditions in the United States and the rest of the world resulted in overvaluing the dollar and grossly undervaluing the currencies of our trading partners, particularly those of France, West Germany, and Japan.

A more realistic realignment of the currency values to each other therefore became the first order of business in the fall of 1971. There was sharp disagreement between the United States and her ten largest trading partners in the Western World (the so-called Big Ten) as to how to go about it. The U.S. recommended an upward valuation (appreciation) of the undervalued currencies relative to the U.S. dollar, while the general desire of the Big Ten was a direct devaluation of the dollar.

When no agreement was in sight, the President of the U.S. on August 15, 1971 declared that:

1) foreign held dollar balances will no longer convert to gold and

2) a 10% protective duty on commodities imported to the U.S. would apply temporarily. Following months of hard negotiating, an agreement was finally reached in December 1971 resulting in:

1) appreciation of the Western foreign currencies relative to the U.S. dollar by an average of 8.5 percent and

2) U.S. agreement that the German mark, French franc, and Dutch guilder will have no fixed rate but will find their values to the dollar on a "floating" basis determined by these countries' demand and supply of dollars.

It was hoped that this agreed upon realignment of currency values to each other would affect favorably the U.S. balance of payments since U.S. export goods would become less expensive and more competitive abroad while import goods became more expensive in the U.S. The expansion of U.S. exports and the shrinkage of U.S. imports were predicted to develop a U.S. trade surplus, eliminate the overall payments deficit, and restore international confidence in the dollar abroad; then a new and permanent international monetary system could be arranged.

The Prospects for the Future

The hopes attached to the December 1971 agreement did not materialize. The U.S. trade deficit kept on growing; it amounted to over $500 billion in February 1972 and over $800 billion in April 1972. It appears now that it will take a substantially longer time before the U.S. balance of payments deficit problem is solved. And solving this problem is a necessary prerequisite to setting up a new international monetary order to replace the defunct Bretton Woods arrangement.

When the U.S. economic house is put in order and the confidence in the dollar abroad is restored, still another problem remains and will require solution jointly by all partners involved. This second problem arises from the fact that international trade among the Western countries expanded at a rate faster than financing ability (under the old Bretton Woods system tied to gold holdings) expanded. This was recognized by the international monetary community. The International Monetary Fund (an agency of the United Nations in monetary affairs) devised as early as 1967 the so-called Special Drawing Rights (SDRs). Unlike gold, SDRs are merely bookkeeping entries in the special account of the International Monetary Fund—hence, the use of the name "paper gold." SDRs are used only in intergovernmental transactions, and their supply is not dependent on the mining of gold, nor upon the holdings of the reserve currencies. They are created by the decision of the I.M.F. In 1970 about 3.5 billion SDRs were distributed among the member nations. After having acquired SDRs, a country is free to use them as the need arises to cover balance of payments deficits. The country may use its SDRs to buy needed foreign currencies from other members of the I.M.F. Member countries are willing to accept SDRs because of the certainty that they can always exchange the acquired SDRs for other currencies.

The creation of SDRs (in fact a new "fiat reserve assets") was an important first step toward the development of the concept of a "World Central Bank." It is expected that the concept of this new reserve asset will play an important role in the new international monetary system which must be created.

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The above manuscript has been adapted from an earlier one printed in the October 1971 issue of "Midsouth Business and Economic Review".

TWENTY-FIVE YEARS AGO—

From "THE WOMAN CPA," June 1947

I think the most dangerous things in the world and the ones that have caused continual turbulence are the inequalities, the senseless, man-made inequalities that could be done away with—social inequality, economic inequality, race inequality, sex inequality—they mean not only unhappiness, but terrible waste. It may be suggested that after these inequalities are abolished, the real inequalities begin, and with that I agree. But the others are inherent inequalities which have always benefited the race—inequality of mind, of emotional powers, of strength, or of beauty. In our time it looks as if economic equality is the one we are first headed toward abolishing. But I believe, of all the inequalities, sex inequality may have caused the most waste.

—MARY COLUM, in "Life and the Dream." (Doubleday & Co.)

TO CAPITALIZE OR NOT TO CAPITALIZE

If William Shakespeare had been an accountant advocating capitalization of leases on the balance sheet, Hamlet's famous soliloquy in Act III Scene I might have read as follows.

Barbara Schomaker
St. Louis, Missouri

*To capitalize, or not to capitalize, that is the question:
Whether 'tis nobler in the mind to suffer
The slings and arrows of outrageous noncomparability
Or to take arms against a sea of misinformations
And by opposing end them. To capitalize—to footnote—
No more; and by capitalizing to say we end
The problem, and the thousand misinterpretations
That a footnote is heir to. 'Tis a remedy
Devoutly to be wished. To capitalize—to footnote—
To footnote—perchance to inform; ay, there's the rub!
For in that footnote what information may come
When we have shuffled it to obscure position
Must give us pause. There's the respect
That makes past conventions of so long life.
For who would bear the ills of footnotes,
The accountant's wrong, the investor's delusion,
The pangs, of distortion, the law's delay,
The indifference of authorities, and the spurns
That logic endures of the unworthy accountant
When he himself might his position make clear
With a capitalized asset? Who would these inadequacies bear,
To mislead and distort under such an accounting procedure.
But that the dread of something after capitalizing—
The undiscovered future, to whose values
No accountant goes—puzzles the mind,
And makes us rather bear those ills we have
Than fly to others that we know not of?
Thus conservatism does make cowards of us all,
And thus the balance sheet
Is sicklied o'er with the pale cast of inadequacy
And accountants of great thought and practice
With this regard their currents turn awry
And lose the name of action—Soft you now!
The conservative accountant!—In all writings
Be thy sins rememb'red.*

BARBARA SCHOMAKER is Controller of Malcolm Bliss Mental Health Center in St. Louis, Missouri.

Miss Schomaker, who has just completed a year as President of the St. Louis Chapter of ASWA, received her bachelor's and master's degrees from St. Louis University.

EDITOR'S NOTES

(Continued from page 4)

Miss Guimond

The ASWA president has spent her entire career in private industry. Prior to moving to California and the intricacies of real estate and land development, she was employed by a dress manufacturer in Chicago.

Perhaps it was her experience in the clothing industry which caused her to develop an interest in sewing—a hobby which she has had to forego in the past few years when she has been such a busy member of the ASWA National Board of Directors.

She has served her local ASWA chapter, California Citrus Belt, in many capacities, including that of president.

Miss Guimond is also active in Beta Sigma Phi, an international sorority, and in Soroptomist Federation of America.

Miss Welch

change in the attitude of others toward women in the professions and in business." With this in mind, her goals for AWSCPA include increased participation with other women's groups involved in the problems of women in business and increased participation of AWSCPA members in the work of their Society, particularly in their own community.

Miss Welch has an A.B. in Economics from Stanford University and has taken many accounting and related business courses at various other California colleges and universities.

The AWSCPA president began her career as a stock and bond analyst for Bank of America. Later she worked in several departments of state government before she joined the California Community Colleges (from which she will retire in August of this year).

Immediately after the Joint Annual Meeting of ASWA-AWSCPA this year, Miss Welch will leave to attend the International Congress of Accountants in Sydney, Australia. After the Congress (she also attended those in New York and Paris), she hopes to visit a few places which she has not previously visited in her many trips to foreign countries.

Along with foreign travel, this fourth generation Californian finds following the stock market fascinating and lists *Barron's, Forbes,* and *Wall Street Journal* as her favorite "paperbacks."

In addition to her long-time service to AWSCPA, she is a member of AICPA, the Sacramento Chapter of ASWA, and the California Society of CPAs. She has compiled a "Governmental Accounting and Auditing Selected Bibliography" which is being distributed by the California Society of CPAs to auditors involved in city, county, school district, and state audits.

We recommend that our readers consider the AWSCPA Educational Foundation when planning contributions—either on a personal or business basis. The goal of the Foundation is the advancement of education in the field of accountancy. Contributions are, of course, deductible for income tax purposes.

Inquiries concerning the Foundation's current activities (or contributions) may be directed to the Foundation's President:

Dorothea Watson, CPA
3005 N.W. 12th Street
Oklahoma City, Oklahoma 73107

We hope you note that our Reviews section this issue has "spilled over" onto the back cover.

THEORY AND PRACTICE

Current Studies and Concepts

MARGARET L. BAILEY, CPA, Special Editor
Wheat Ridge, Colorado

STUDY ON ESTABLISHMENT OF ACCOUNTING PRINCIPLES

What are accounting principles? Who establishes them? Should there be a change in the procedure by which accounting principles come into being? These are questions which have been given a great deal of thought in the last year by a special study group set up by the American Institute of Certified Public Accountants (AICPA). That group has now reached its conclusions and made its recommendations to the AICPA Board of Directors. Because the subject is of vital concern to all those in the accounting profession, the AICPA distributed a summary of those conclusions and recommendations immediately to its members.

The seven-man study group consisted of two CPAs in public practice, one CPA in private industry, an investment banker, an educator, an attorney who is a former commissioner of the SEC, and an executive of General Motors. Many readers who serve the multitude of small businesses may note with some annoyance that the viewpoint of the small or medium-sized company had no representation on this particular study group.

The report of the study group includes an observation that during the past fifteen or twenty years accounting "principles" have been issued by the Accounting Principles Board (APB) of the AICPA and its predecessor, the Committee on Accounting Procedure. Because many of the opinions expressed by these bodies had little to do with "principles" as normally understood, it is now recommended that the term "financial accounting standards" be used instead of "accounting principles."

The question of whether such standards should be formulated by a governmental authority or by a private board was considered. The advantages and disadvantages of both arrangements led the study group to conclude that the task should continue to be the responsibility of the private sector with appropriate review by the SEC.

The present APB is composed of 18 members —all of whom are members of the AICPA—who serve without compensation and who continue their regular duties with the company with which they are affiliated. While this arrangement tends to add strength to the pronouncements of the APB, it does create other problems. The present Board serves only on a part-time basis, of course, and simply cannot devote sufficient time to the task to achieve the desired results in a short period of time. Nor can its members entirely divorce themselves from their own client and company pressures. Likewise, the viewpoint of non-accountants is not given the weight that sometimes may be necessary in a particular situation.

Proposed Changes

The study group has proposed four major changes from present arrangements:

1) In order to better meet the present needs, the study group has proposed to set up an entirely new organization which is completely separate from all other professional bodies and which would be called the "Financial Accounting Foundation." It would have a governing body of nine trustees—the President of the AICPA and eight other members appointed by the AICPA Board of Directors. Those eight trustees would consist of four CPAs in public practice, two financial executives, one financial analyst, and one educator. The trustees would have two principal duties—to appoint the members of the "Financial Accounting Standards Board" and to raise the money for its operations.

2) After a transitional period, the members of the Financial Accounting Standards Board would issue the "standards" which accountants observe. All persons on this Board would be on a full-time salary basis appointed for a five-year term by the trustees. There would be seven such members, one of which would be designated by the trustees to serve as its Chairman. A second five-year term would be possible, but during their terms of office they could have no other business affiliation. Four of these Board members would be CPAs from public practice, the other three having extensive experience in financial reporting but not necessarily holding CPA certificates.

The affirmative vote of five out of the seven members would be required before a standard could be issued. Interpretations of those standards would also be issued. The new Board would normally carry out its functions in public.

3) The third proposal is that the Trustees of the Foundation also establish a twenty member Advisory Council to work in an advisory capacity with the Standards Board. The Advisory Council would also be appointed by the Trustees to serve one-year terms, which could be renewed indefinitely, and would serve without remuneration. This Advisory Council would be drawn from many occupations. Its function would be to consult with the Standards Board as to priorities, help set up task forces for detailed investigations when required, react to the Board's proposed standards, and assist in other ways when called upon.

4) The final recommendation of the study group was that research projects be carefully defined and controlled to make sure they are relevant to the Board's needs and are carried out efficiently. Such projects should be worked on a full-time basis.

The estimated cost of the study group's proposals was between two and a half and three million dollars per year. Among the advantages which are hoped to be obtained over the present structure are:

1. An Accounting Standards Board which would be free of private interests that might conflict with the public interest,
2. A Board which would devote undivided attention to its tasks and deal more efficiently with its problems,
3. A Board structured from more participating groups which would provide a broader support for its pronouncements,
4. Greater financial support for its work,
5. A Board with strong support from the public accounting profession—which was considered to be essential to the effective enforcement of its Standards, and
6. A Board better able to supervise research that must sometimes precede the work of the Board.

Conclusions

The proposals of the study group deserve your thoughtful consideration. The expressed goal of this dedicated group of persons is to improve reporting methods and increase public confidence in the financial information which is provided to stockholders and other users of financial information. We can make our contribution toward this goal by making a sincere effort to understand the pronouncements which may be forthcoming and by endeavoring to apply the "standards" (or "principles") to those statements which we prepare regardless of how small a company or how few may be the people affected.

For, in this editor's opinion, it will only be through countless day-to-day applications by small companies that accounting "standards" will eventually be achieved—and the public confidence be earned.

Editor's Note:

Subsequent to the time this article first went to the printer, the Council of the AICPA has *voted to adopt the recommendations of the special study group.* The present APB will be replaced by a seven-person body to be entitled the Financial Accounting Standards Board.

TAX FORUM

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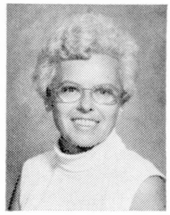

NEW DOMESTIC INTERNATIONAL SALES CORPORATION (DISC) Part 2

The May issue of the Tax Forum discussed the taxation and qualification requirements of the DISC corporate entity. This month, amounts deemed distributed to shareholders and the treatment of actual distributions out of earnings and profits will be reviewed.

As stated in the May issue, under the DISC tax system the profits of the DISC are not taxed to the corporation. Except as provided in the DISC legislation, stockholders are taxable on the earnings and profits of the DISC in the same manner as are shareholders of any other corporation. The principal differences in methods of taxation are:

1. Certain income, whether or not distributed, is deemed to have been distributed as a dividend to DISC shareholders.

2. A corporation that ceases to be a DISC is considered to have distributed to its shareholders its accumulated *untaxed* income.

3. Upon disposition of stock in a DISC, a shareholder recognizes gain as a dividend to the extent of the untaxed DISC income attributable to his pro rata share of stock.

4. Dividends (whether actual or deemed) received by a shareholder from a DISC do not qualify for the dividends received deduction to the extent they are from income which has not been taxed to the DISC.

5. A corporate DISC stockholder is entitled to indirect credit for foreign taxes paid by the DISC to the extent of dividends, actual and deemed, attributable to the DISC's qualified export receipts. However, excess credits cannot be used to offset the shareholder's U.S. tax liability on income received from the DISC.

Deemed Distributions in Qualifying Years

DISC shareholders are generally not taxed on income in excess of current earnings and profits. They are, however, taxed on the following items of income earned during a qualifying year, whether or not actually distributed. These distributions are deemed to have been made on the last day of the DISC's taxable year.

1. *Interest derived from producer's loans.*

When a DISC subsidiary lends money to a parent corporation as a producer's loan, this rule may be negated by eliminating interest. If interest is charged on the loan to a parent stockholder, the income will be offset by a deduction for interest expense incurred.

2. *Gain on the sale of property (other than qualified export assets) previously transferred to the DISC in a transaction in which gain was not recognized to the transferor (contributions to capital or tax-free exchange).*

There is a dual purpose for taxing this income to a shareholder. Since it does not arise from an export activity, it is not eligible for tax deferral. Secondly, it prevents the transfer of appreciated property to the DISC solely for the purpose of achieving tax deferral on the gain when subsequently sold by the DISC.

3. *Gain on the sale of depreciable property previously transferred to the DISC by its shareholders in a tax-free exchange.*

When a DISC sells property subject to depreciation recapture in the hands of its shareholder, each shareholder is deemed to have received a distribution equal to his pro rata share of a portion of the gain recognized by the DISC. The gain deemed distributed is limited to the ordinary income that would have been received by the shareholders had the property been sold on the day it was transferred to the DISC. If the DISC has more than one stockholder, a tax-free transfer of Section 1245 or 1250 property to the DISC by a single shareholder will shift a pro rata share of depreciation recapture to the other stockholders on subsequent sale of the property by the DISC.

4. *50% of the taxable income of the DISC in excess of the amounts deemed distributed under 1, 2 and 3 above.*

Each shareholder of the DISC is treated as having received a taxable dividend distribution equal to his pro rata share of one-half of the excess of the DISC's taxable income for the year over the total amount deemed distributed with respect to interest on producer's loans, gain on appreciated property and gain on depreciable property. The operation of this rule is illustrated by the following example:

DISC taxable income		$1000
Less deemed distributions to shareholders:		
Interest on producer's loans	$25	
Gain on ineligible property	45	
Depreciation recapture	30	100
Adjusted taxable income		900
50% of adjusted income		450
Additional deemed distributions to shareholders		$ 450
Total deemed distributions to shareholders ($100 deemed distributions plus $450 additional deemed distributions)		$ 550
Taxable income not considered distributed ($900 adjusted taxable income less $450 taxed currently)		$ 450
Tax deferred thereon ($450 at 50% tax rate)		$ 225

5. *The increase in foreign investment attributable to the DISC's producer's loans for the taxable year.*

This amount is limited to the lesser of: (1) the net increase in foreign assets by members of the controlled group which includes the DISC, (2) the actual foreign investment by domestic members of the controlled group, or (3) the amount of outstanding producer's loans by the DISC to members of the controlled group. This rule is meant to prevent the investment abroad of tax deferred profits borrowed by DISC affiliates.

A dividend resulting from an increase in foreign investment is the one exception to the provision that deemed distributions in qualifying years are taxable only to the extent of the DISC's current earnings and profits. For this purpose, earnings and profits for the taxable year include accumulated (non-taxed) prior earnings and profits.

Deemed Distributions on Termination or Disqualification

While a DISC election continues in effect and the corporation continues to qualify as a DISC, its tax-free income may be accumulated and the stockholders will be taxed only on actual distributions plus the annual deemed distributions. However, if the corporation revokes its DISC election or fails to qualify as a DISC with respect to any taxable year, the corporation's tax deferred DISC income accumulated during the immediately preceding consecutive taxable years is deemed distributed as a taxable dividend pro rata to its present stockholders. Such distributions are deemed to be received by the shareholders in equal installments. The law provides an interest-free pay-out period for reporting these installments over the lesser of ten years or the number of years the corporation was a qualified DISC. Any actual distributions made during the period of deemed distributions will be added to the current year's installment and will reduce the last installments in reverse order. This enables the stockholders to have a certain flexibility in determining when they will report deemed distributions for tax purposes.

Gain on Disposition of DISC Stock

To the extent of the tax deferred DISC income, a stockholder of a DISC or former DISC may receive ordinary income when he disposes of his stock at a gain. This ordinary income is limited to two basic types of transactions:

1. *A transaction in which gain on the disposition is recognized; i.e., a redemption or sale by the shareholder of his stock.* Upon redemption, gain will be realized as a dividend equivalent to the proportionate share of DISC income accumulated while the shareholder owned the stock. A corresponding decrease in the DISC's accumulated income should be made to prevent an amount treated as a dividend to the redeeming stockholder from subsequently being again taxed as a dividend to other shareholders. When gain on the sale of a share of DISC stock is treated as a dividend, any subsequent actual distribution from accumulated DISC income to the transferee of such share is considered a distribution from previously taxed income. This obviates the double taxation of accumulated DISC income with respect to a share of transferred stock.

2. *A transaction where realized gain on the disposition is not recognized, but as a result of which the DISC or former DISC ceases to exist as a separate corporate entity.* Certain transactions that are generally non-taxable in nature will trigger recognition of dividend income on the part of DISC shareholders. For example, in an "A" or "C" reorganization where the DISC is the acquired corporation and is either liquidated or merged into another, the recognized gain will be that portion attributable to DISC income accumulated while the shareholders owned the stock.

The realized gain in a "B" reorganization, even when the DISC is acquired, will not result in recognition of gain, since the acquiring corporation will "step into the shoes" of the previous DISC shareholders and DISC status will be maintained. The same treatment is afforded in an "F" reorganization, or when a DISC is split into two corporate entities.

Gifts of DISC stock or transfers by reason of the death of a shareholder will not result in ordinary income treatment to the transferor as no gain is realized on the transfer. However, the new basis of stock acquired from a decedent will be reduced by an amount equal to the dividend the decedent would have included in gross income had he lived and sold the stock on the estate valuation date.

Division of Earnings and Profits

DISC law provides for the division of earnings and profits into three categories:

1. *Tax-deferred income, called "DISC Income."*

This category consists of the current year's untaxed earnings and profits plus accumulated prior years' deferred income reduced by any actual or deemed dividends treated as made out of DISC income.

2. *Previously taxed income.*

This represents DISC earnings already taxed to shareholders as deemed distributions but not actually distributed. It may include distributions both when the corporation was and was not qualified as a DISC.

3. *Other earnings and profits.*

This category includes earnings and profits accumulated while the corporation was not taxed as a DISC. Since these "normal" earnings and profits were subject to tax at the corporate level, they are eligible for the dividends received deduction when distributed.

The table below sets forth the order in which various distributions would be applied to earnings and profits.

In Conclusion

These two issues of the Tax Forum have presented a cursory review of only the major provisions of the new DISC legislation. There are several areas, for example the special rules pertaining to domestic filmmakers and the conversion of an export trade corporation to a DISC through a tax-free transfer of property, that have not been covered in this article. In considering the creation and operation of a DISC, a careful evaluation of all aspects of DISC law should be made in order to properly weigh the advantages and disadvantages as they would relate to an individual situation. Although the liberal pricing rules and lack of stringent substance requirements offer substantial benefits, the various restrictions on the investment of deferred income may present problems in maintaining a qualified DISC status.

Category	Taxability	Deemed Distributions	Deficiency Distributions To Meet Qualifications*	Actual Distributions	Losses
1. DISC Income	Taxable—no dividend received deduction	X	1	2	2
2. Previously Taxed Income	Not Taxable		3	1	3
3. Other Earnings and Profits	Taxable—dividend received deduction		2	3	1

*NOTE: In order to maintain its DISC status, a deficiency distribution would be required in the year a corporation did not meet the 95% gross receipts and assets test.

REVIEWS

Writings in Accounting

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"Statement of Funds: A Glimpse of the Future?" Aubrey C. Roberts and David R. L. Gabhart, **The Journal of Accountancy,** Vol. 133, No. 4, April, 1972.

Roberts and Gabhart propose radical changes in the traditional statement of source and use of funds [now recommended to be entitled "Statement of Changes in Financial Position."] While the funds statement furnishes significant data not discernible from the balance sheet and income statement, the authors believe the relevance of the funds statement can be enhanced if the statement's viewpoint is altered to reveal financial information about the future.

The balance sheet simply relates account balances at a specific date, and the income statement presents past performance for a period of time. However, Roberts and Gabhart would revise the funds statement to provide information about future operations. One of their objections to current funds statement construction is the netting of revenues against operating expenses and the presentation of net income as a source of funds.

Further, Roberts and Gabhart believe the focal point of the funds statement should be applications of funds rather than sources of funds. Transactions that may be categorized as uses of funds are inherently related to future operations of the business and, as such, should receive closer reader attention.

The accountant can assist readers in evaluating a firm's future prospects by expanding and rearranging the applications section to include details on expenditures that affect the firm's future. It is observed that a business enterprise usually can obtain funds from sources such as investors and creditors. However, the future success of the firm depends upon wise application of those funds.

The authors suggest a substantial revision and expansion of the traditional funds statement. Sources of funds would show revenues as a separate fund item, while the fund applications section would include all operating expenditures requiring funds. Obviously, the funds statement would be far more detailed than presently constituted. However, the additional data would have enormous potential value for investor analysis.

A second departure from the traditional funds statement is the authors' recommendation that funds be defined as net quick assets instead of working capital. By excluding inventories and prepaid items from the definition of funds, more homogeneity is obtained within the funds category. Also, changes in inventories would now be classified with assets such as plant and equipment; and inventory build-up may reflect an application of funds of significance to future operations of the firm.

The third proposal of Roberts and Gabhart is that the modified funds statement should be a comparative statement covering perhaps a five-year period. A comparative funds statement would allow readers to detect patterns of continuity or discontinuity in fund commitments as well as in sources.

In summary, this proposal for expansion and reclassification of the traditional funds statement merits the profession's attention. The fact that the funds statement as now constituted is sanctioned by the AICPA and the SEC does not alter the need for improvement. This short paper by Roberts and Gabhart should be analyzed by all accountants desiring to improve the relevance of general purpose financial statements.

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"Materiality–Through the Looking Glass," William Holmes, **The Journal of Accountancy,** Volume 133, Number 2, February 1972.

William Holmes presents an interesting discussion concerning the application of the materiality concept in accounting. Selected excerpts from scholarly writings during the thirty-year period 1938-1968 advocate either the continuance of using "judgment in each situation" or the need for definition.

Mr. Holmes's research reveals that the materiality concept has a British background rooted in legal proceedings, which produced decisions based on judgment, and that the early chartered accountant and the American accountant who followed thought of materiality in this general legal context. He points to the inclusion of the definition of materiality in SEC regulations as indication that here consideration deals with it as a part of accounting methodology and notes movement in the direction of definite meaning. A brief coverage of "standards, guidelines, and border zones" makes available some fundamental information on the proposals to get on with the establishment of a definite meaning. There is, however, a reminder that accounting information is only one variable in most problem areas when considering the concept. Reference to the refusal of the courts to define the legal term "fraud" is offered in support of those who favor the exercise of judgment.

In conclusion he states: "My personal opinion is that we must widen our understanding and narrow our judgments—short of official standards."

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"Accounting This Month"—a new periodical. (Information Specialists, P.O. Box 8699, White Bear Lake, Minnesota 55110).

A new publication which sells for $15.00 per year appeared on the scene in late 1971. It contains the current tables of contents from eleven accounting periodicals and seven related business periodicals. The magazine includes the articles and books classified by major accounting subjects for reference. The "highlights" section of the magazine describes the major accounting events of the month and refers the reader to the sources of the information.

Most accountants have neither the budget to subscribe to nor the time to read all eighteen of these periodicals. This magazine provides capsule information on what has been recently published. It will enable the accountant to prepare a reading list of important articles before he visits his local library facilities. (Since many of the articles are described in brief form, it may even save a needless trip to the library.) The periodicals reviewed are: *Accounting Review, Federal Accountant, Financial Executive, Internal Auditor, Journal of Accountancy, Journal of Accounting Research, Journal of Taxation, Management Accounting, Managerial Planning, National Public Accountant, CPA Journal* (formerly *New York Certified Public Accountant), Barron's, Business Week, Dun's, Forbes, Fortune, Harvard Business Review, Nation's Business.*

M.E.D.

"Governmental Accounting in China During the Chou Dynasty (1122 B.C.-256 B.C.)," Philip Fu, **Journal of Accounting Research,** Vol. 9, No. 1, Spring 1971.

Confucius, Mencius and Lao Tzu lived and philosophized during the 866 year span of the Chou Dynasty in China, which had a sophisticated system of government accounting. According to Philip Fu, achievements in accounting ranked in equal importance with the philosophic contributions of the period. (Mr. Fu is Chairman, Department of Business Administration, Chung Chi College, The Chinese University of Hong Kong.)

A period of such antiquity (1122 B.C.-256 B.C.) naturally connotes a rural, simple agricultural society. So it was, and yet the needs of government were substantial and the administration well organized. "The Chous," writes Philip Fu, "undoubtedly recognized the importance of the fund system and its basic principles."

Their accounting system set aside resources for five kinds of specific activities. In contemporary translation these would be general revenue, special revenue, welfare, relief, and reserve funds, with each fund refined by further subdivisions. Here translation creates an effect both quaint and strange, but nonetheless fascinating. A sacrifice fund, for instance, was a component of the special reserve funds grouping, along with a hospitality fund, sacrifice utensils fund, embroidered garments fund, pearl fund, and feather and hair fund.

The names are obsolete, but not the accounting concepts. The Chou administrators recognized a budget system and a fiscal year as separate from the calendar year. They made provision for financial reporting and auditing. Their calendar year, naturally enough, had its origin in the recurring patterns of agricultural society. It had been established another thousand years back in time from the ancient Chous and remained the official Chinese calendar until it was replaced by the solar calendar when the Republic of China was established in 1911.

Now that chinoiserie is suddenly so chic, this glimpse of an historic accounting wisdom in China is both professionally engaging and fashionable.

Constance T. Barcelona
The Camargo Club

There's more on the back page!

The following articles have not been reviewed but may be of interest to our readers:

"Earnings Per Share: A Measure of Sustainable Growth," G. Holmes, **Accounting and Business Research,** Spring 1971.
Illustrations are provided for the computations of earnings per share based on past performance, future potential, and earnings adjusted for inflation.

"The Development of Accountancy Links in the Commonwealth," T. J. Johnson & M. Caygill, **Accounting and Business Research,** Spring 1971.
A fascinating account of the history of British professional bodies from 1880 on. The authors hold that some British professional bodies developed overseas activities in the Commonwealth to enhance their British status. The authors conclude that Commonwealth countries now give less recognition to these professional societies.

"Green for VAT," J. S. Bradley, **Accountancy,** June 1971.
The author discusses the value added tax (VAT) including its background and the principles involved.

"The Case for Shareholders' Committees," M. G. Wright, **The Accountant,** May 1971.
The author urges that publicly held firms should have independent shareholders' committees. He advocates that they should be established by law and suggests their duties and responsibilities.

"Pacific Acceptance Corporation," K. B. Edwards, **The Accountant,** June 1971.
This article discusses a law suit against an Australian affiliate of an international accounting firm. The auditors were required to pay heavy damages because they failed to provide their staff (which was inexperienced and inadequately supervised) with an adequate audit program. In addition, the firm ignored a qualified report which was prepared by the auditors of a subsidiary company.

"Accounting for Goodwill," G. T. Gilbert, **Canadian Chartered Accountant,** April 1971.
The author laments inconsistent treatment by Canadian accountants for purchased goodwill. He proposes that the excess of purchase price over book value be allocated to specific assets. He also suggests that the time period for amortizing goodwill should be equal to the one used by the buyer when he computed his top offering price.

"Discounted Cash Flow—The Other Point of View," R. M. Adelson, **Moorgate and Wall Street,** Spring 1971.
The author prefers pay-back to discounted cash flow. He feels that DCF, although easy, is based on unrealistic assumptions and conceptions.

"What's Happening in Acquisitions and Mergers?" R. E. Healy, **The Price Waterhouse Review,** Spring 1971.
This article reviews trends in the United States merger movement. The author predicts that there will be an increase in sale or disposal of business units and an increase in venture capital investments. He predicts a decrease in "funny paper" and greater use of common stock in mergers as firms in basic industries continue to diversify.

"Criticism With Love," J. C. Burton, **The Arthur Young Journal,** Winter/Spring 1971.
An accounting professor cautions that the best defense against change is careful consideration, and he sees more of the latter to prevent the former. He suggests a new approach to staff training in the profession and laments trends toward bad teaching in the universities, a decrease in accounting majors, and decline of traditional accounting. He urges accountants to take responsibility and suggests we should encourage the public to recognize that financial statements are approximations, not truth.